State of New Mexico
LEGISLATIVE FINANCE COMMITTEE

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LFC INVESTMENT REPORT FOR THE QUARTER ENDING JUNE 30, 2014

This report details the comparative investment performance of the three investment agencies: the Educational Retirement Board (ERB), the Public Employees Retirement Association (PERA), and the State Investment Council (SIC). It explains how the returns generated by these agencies differed from that of the archetype fund and how management and consultants added or subtracted value. Because long-term performance is an important metric, this report includes fund returns and comparative rankings for the one, three, five, and ten-year periods and attribution analysis for the quarter, one, and three-year periods.

Market Environment

- The U.S. stock market, represented by the Wilshire 5000 Total Market Index was up 4.9 percent, posting its eight consecutive quarterly gain. Fixed income markets turned in solid performance in the second quarter, as U.S. Treasury yields fell at most maturities.
- In the second quarter of 2014, most capital markets managed positive performance despite global political strife and turmoil. Investors globally continue to demand U.S. Treasuries as they provide an attractive yield relative to other developed-market government bonds.

Returns and Ending Balances. Figures 1 through 4 show the ending balance and the returns for the quarter and for the one, three, five, and ten-year periods ending June 30, 2014. The one, three, and five-year returns exceed the investment agencies' respective annual targets, which are 7.5 for SIC and 7.75 for ERB and PERA. Ten-year returns fell short of long-term targets because they reflect lesser investment performance during the global financial crisis, exacerbated by asset allocations that did not include diversification from alternative investments given policy restrictions imposed at the time.

The returns and balances of the STPF and LGPF are shown separately in Figure 1. A portion of the STPF is invested in economically targeted investments (ETIs) that typically perform below-market because the investments are not targeted solely at delivering returns. SIC can justify an ETI's reduced level of expected financial return with the expected economic development benefits that the investment is expected to deliver. The LGPF does not have ETIs in its portfolio and so is a better gauge of SIC's performance. The difference in return between the two is a rough approximation of the opportunity cost of these initiatives.

Figure 1. Ending Balance ($B)
As of June 30, 2014

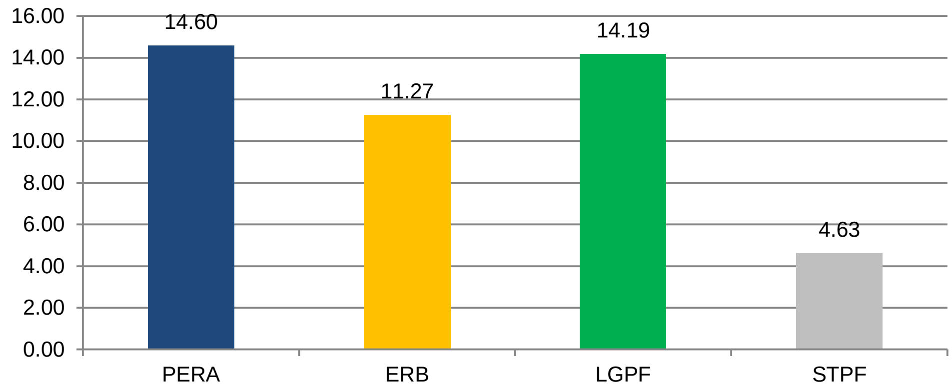
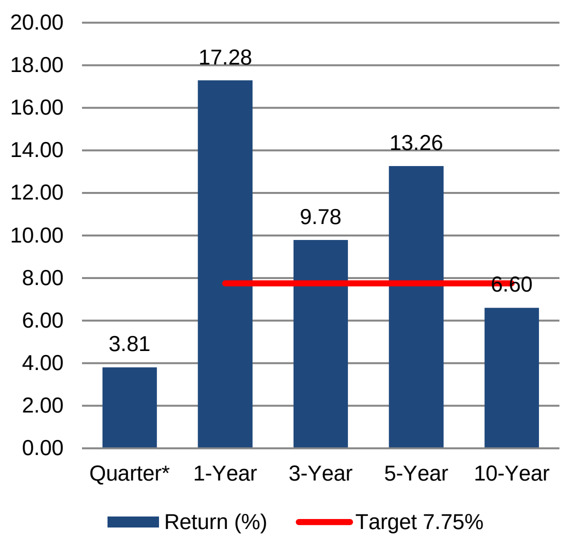


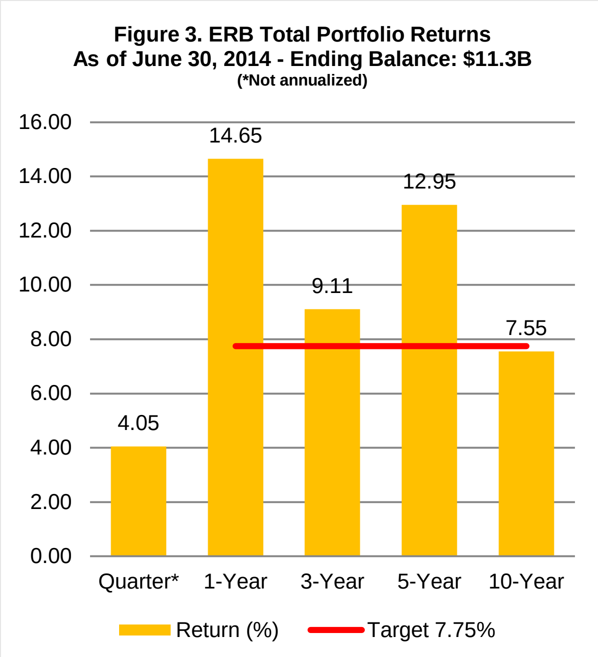
Figure 2. PERA Total Portfolio Returns
As of June 30, 2014 - Ending Balance: $14.6B
(*Not annualized)

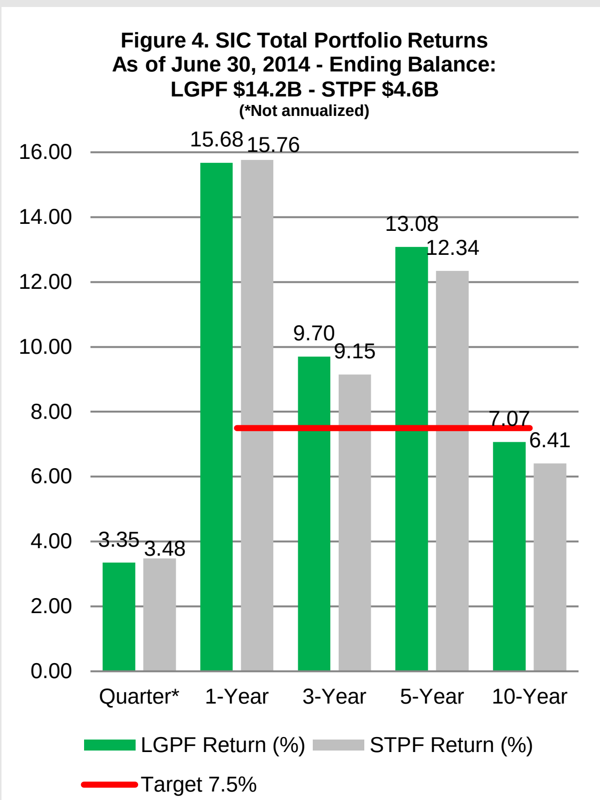


<u>Investment Policy Objectives.</u>

PERA's investment policy establishes the fund's primary objective is to prudently invest assets in order to meet statutory obligations to its members. The fund's assets are managed to reflect its unique liabilities and funding resources, incorporating accepted investment theory, prudent levels of risk and reliable, empirical evidence. Specifically, PERA's board has adopted the following principles:

- Strategic asset allocation is the most significant factor influencing long-term investment;
- Risk is unavoidable;
- Diversification both by and within asset classes is the fund's primary risk control element;
- The fund's liabilities are long term and the investment strategy must therefore be long-term in nature; and
- Sufficient liquidity will be maintained to meet anticipated cash flow requirements, including payments to beneficiaries.





ERB's investment philosophy and techniques are based upon a set of widely accepted investment models. The investment philosophy is summarized as follows:

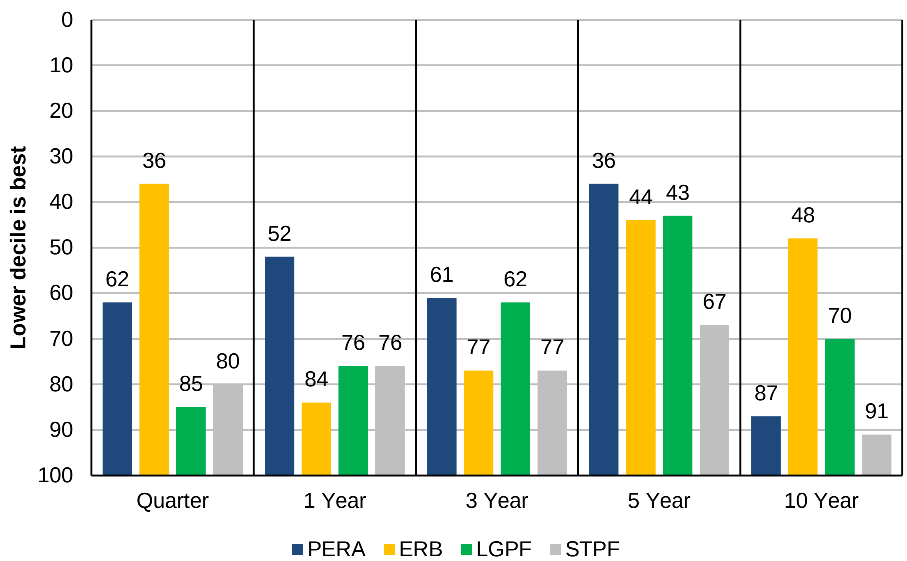
- Develop and maintain strategic asset allocation (SAA) targets and ranges that optimally attain objectives of return and risk;
- When appropriate, ERB seeks to profit from capital market inefficiencies and market dislocations that may occur periodically;
- Investment positions take trading costs into consideration;
- Monitoring of investments and asset managers is a good administrative practice;
- Performance measurement and attribution analysis are essential in assessing effectiveness of investment strategies; and
- Rebalancing of the fund's assets is necessary for attainment of investment objectives.

SIC invests the Severance Tax Permanent Fund (STPF) and the Land Grant Permanent Fund (LGPF), and its investment goals are to preserve the permanent endowment funds and to provide future benefits by growing the funds at a rate at least equal to inflation. SIC seeks to manage the funds to ensure that future generations receive the same or greater benefits as current beneficiaries, while maximizing current distributions through time to provide current revenue sources to the state's general fund. Total return, which includes realized and unrealized gains, plus income, less expenses, is the primary goal of the funds. In order to meet the investment objective, the SIC has adopted the following principles:

- To preserve the purchasing power of the corpus and to provide benefits, the funds should have a long-term strategic asset allocation (SSA). The SSA is the most important determinant of return variability and long-term total return;
- Risk is an unavoidable component of investing;
- Diversification by asset class and within asset classes is a primary risk control element; and,
- Sufficient liquidity will be maintained to meet the anticipated cash flow requirements of the funds.

<u>Peer Total Return Rankings</u>. Figure 5 shows peer total return rankings for the agencies' large funds for the quarter, one, three, five, and ten-year periods. A lower rank (1st is best) denotes better performance when compared to other public funds. These comparisons are made using the Wilshire Trust Universe Comparison Service (TUCS), a benchmark for the performance and allocation of institutional assets that includes approximately 77 public funds with more than $1 billion in assets.

Figure 5 - TUCS Universe Rankings
(public funds > $1 billion) For Period Ending 6/30/14



Staff from all three investment agencies notes their respective performance rankings in the long-term are affected by limitations of their asset allocations at the time and by adverse economic conditions during the recession. That means before the agencies changed their investment policies toward more diversified portfolios (through the use of alternative assets), the volatility of equity markets during the last 10 years had a larger effect on their returns. House Joint Resolution 16 will put to the voters at the next general election a proposed constitutional amendment to strike the provision[1] of the LGPF that no more than 15 percent of the book value of the fund may be invested in international securities at any one time, allowing the SIC to implement a SSA comparable to other peer funds.

<u>Attribution Analysis</u>. There are three basic ways that a fund's returns can differ from the average: the policy, allocation, and manager effects.

Policy Effect. A fund can have a long-term policy allocation target that has a more or less aggressive proportion of growth assets such as stocks. For instance, if retrun-seeking domestic assets such as U.S. stocks (equities) performed well during a period, an index that has more domestic equities should outperform the average. Measured in isolation against a defined peer group, such a change in performance is known as the "policy effect," and it is an essential responsibility of the fund's trustees based on investment mandate and associated asset allocations.

[1] Article XII, Section 7 of the Constitution of New Mexico.

Figure 6 shows the funds' policy effect as measured by comparing the funds' policy indices to the TUCS median fund actual return to allow uniformity and consistency across the three funds. The TUCS median return is gross of the allocation and manager effects, and the measure is therefore a rough estimate of the policy effect. (The investment agencies' policy target allocations are included in Figure 8, on page 10 of this report.)

Figure 6 - Quarterly, One-, and Three-Year Policy Effect (%) For Period Ending 6/30/14

PERA's policy index lagged the median fund by 0.17 percent in the quarter, and 1.19 and 1.55 percent less during the one and three-year periods, respectively.

ERB's quarterly policy index performed 45 basis points below the TUCS median fund performance. Also, the fund trailed the median fund by 349 basis points in the one-year period and by 141 basis points in the 3-year period.

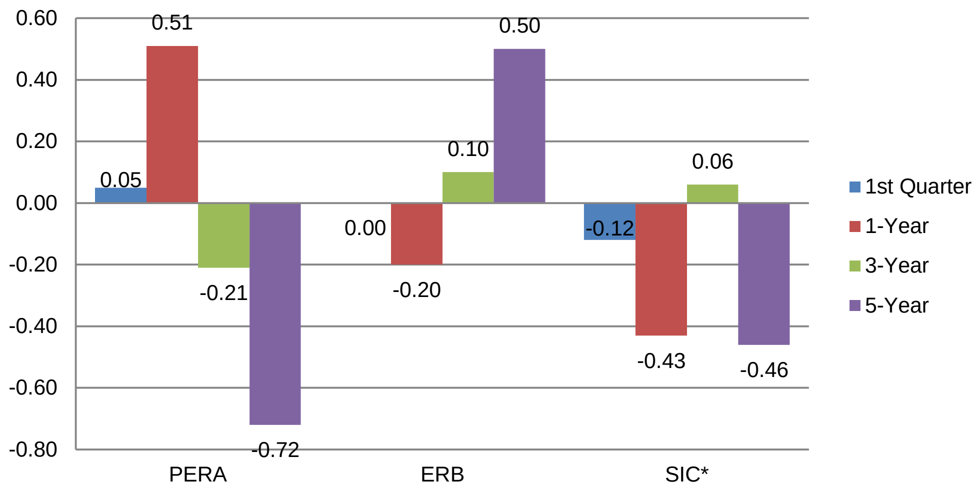
SIC's LGPF investment policy as of June 30 calls for a 31 percent allocation toward domestic equities, and a 15 percent allocation toward non-U.S. equities. Hence, SIC's policy index performed 42 basis points below the median fund in the quarter and 94 basis points below in the one-year period. The three-year policy effect is 59 basis points above the median fund performance.

Allocation Effect. The second way that a fund's return can be affected is by deviation from asset allocations called for by policy. As a matter of practice, investment officers are constantly confronted with allocation decisions when transitioning or rebalancing portfolio managers or asset classes.

Asset prices and values can vary in the short run, causing the allocation toward an asset class to drift from its long term target. Almost all rebalancing policies contain some flexibility for staff or the chief investment officer to operate within set boundaries. The three funds constantly see contributions coming in and distributions going out. Further, cash is being generated in some portions of the portfolio, and called or used in others, which can also cause asset allocations to deviate from policy. The investment officer may have the option of letting money sit in cash or incurring the cost of temporarily covering the allocation through the futures market or some other avenue, depending on policy authority. Rebalancing authority afforded the chief investment officer is dictated by investment policy, resulting in differing degrees of authority delegated by each fund.

The difference between the funds' temporary and long-term allocation is known as the "allocation effect" and is interpreted as investment return added or lost due to that deviation. Figure 7 shows the allocation effect graphically for the quarter, one-year, three-year, and five-year periods.

Figure 7 - Quarterly, One-, Thre-, and Five-Year Allocation Effect (%) For Period Ending 6/30/14



PERA's asset allocation added 5 basis points during the quarter due primarily to an overweight in international and domestic equities. For the one-year period, overweights to international and domestic equities and underweights to real assets and liquid alpha added value, more than offsetting the negative impact of an underweight in private equity and overweights in absolute return and cash, for a total allocation effect of 51 basis points. Deviation from asset allocation detracted 21 basis points for the three-year period with underweights in private equities and fixed income and an overweight in absolute return having the greatest effects.

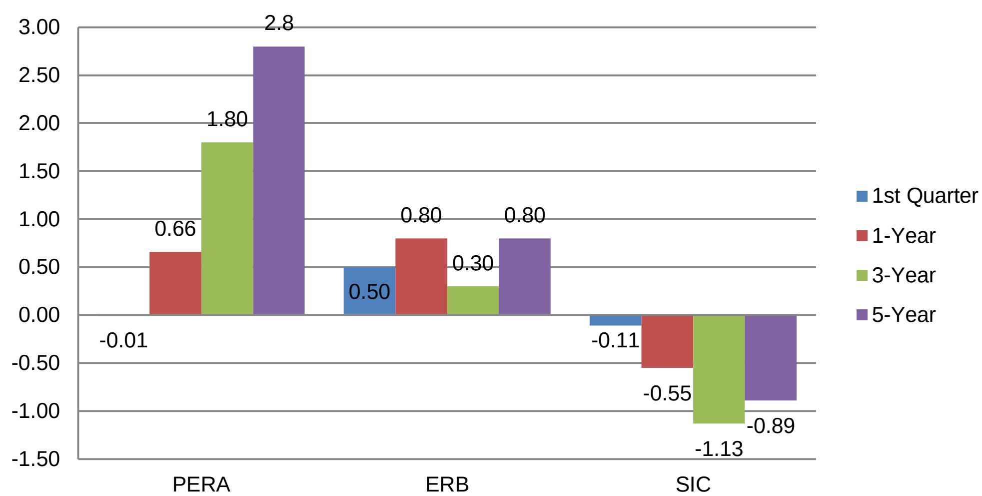
ERB's quarterly allocation effect was zero while one-year results show a loss of 20 basis points, resulting primarily from value lost by deviation from allocation targets in alternatives and in domestic and international equities. Value added in opportunistic credit, risk parity, and in real estate offset losses in real assets and in international equity markets, contributing to ERB's allocation that added 10 basis points during the three-year period.

During the quarter, SIC's return was lowered by 12 basis points because gains from underweight to non-U.S. equity, private equity, real return and to real estate offset value lost due to overweight in fixed income, U.S. equity, and cash equivalent. The one-year allocation effect for the SIC was -43 basis points. Value added by underweight to non-U.S. equity, real estate, private equity, and real return couldn't offset lost value from overweight to fixed income primarily and to U.S. equity, and cash equivalent assets. SIC's investment staff notes a lowered equity exposure hindered quarterly returns, though they are positioned in a somewhat protective manner should the equity markets turn. Also, the attribution under "other" is added to the allocation effect for a net result. This does not affect the other retirement funds to the same degree as it does for SIC because the amount of money transferred among SIC's asset classes is considerably larger.

Manager Effect. The third way that value can be added or subtracted from a fund is through the use of active management, for instance, investment in a low-cost index fund. Alternatively, the fund can employ a manager who will trade individual securities given his perspective of individual stocks. This is known as "active" investing. The difference between the return of the index and the portfolio of the active manager is known as the "manager effect."

Figure 8 shows manager effects for all three agencies during the quarter, one-year, three-year, and 5-year periods. PERA's manager effect was almost zero for the quarter. However, the manager effect of 66 basis points in the one-year period was largely realized through active manager outperformance in fixed income, absolute return, real assets, and real state. PERA's solid three-year manager effect of 180 basis points was largely influenced by fixed income, absolute reurn, real assets and domestic equity. ERB's manager effect in the quarter was 50 basis points. The one-year period shows a manager effect of 80 basis points because of gains in private real estate, global tactical asset allocation (GTAA), and in opportunistic credit that offset losses in private equity composite, non-U.S. emerging market debt, and non-U.S. developed markets equity. SIC's quarterly manager effect[2] show a loss of 11 basis points. The one-year manager effect is negative 55 basis points as value added in fixed income and in absolute return was offset by value lost in private equity, non-U.S. equity, U.S. equity and real estate. SIC notes their three and five-year manager effects are influenced by legacy managers and by portfolio restructurings that have been in place for a short amount of time.

Figure 8 - Quarterly, One, Three, and Five-Year Manager Effect (%) For Period Ending 6/30/14



Passive vs. Active Total Portfolio Investment Management. ERB, PERA, and SIC must make several decisions when implementing their respective investment policies. For instance, the policy must call for an asset allocation that appropriately diversifies the portfolio and balances risk and return. Agencies need

[2] The SIC notes that its net-of-fees performance analysis is based upon an estimate of SIC's investment performance developed by RVK.

to make decisions on how to implement the allocation, including whether to use an active manager or passively invest in an index.

Chief investment officers consider using active managers or investing in an index in an effort to maximize risk-adjusted net returns. In doing so, they use the concept of "alpha" to measure the security selection against an actively-managed portfolio with a given benchmark. Alpha is the return in excess of a given benchark that is derived from manager skill. The objective when deciding to engage in active management should be to generate enough alpha to more than pay for the active management fees it costs to obtain. The active and passive distribution of all three investment agencies is described below using data as of June 30, 2014:

- Of PERA's approximately $8.1 billion in public equities, $3.6 billion (44 percent) is actively managed. Further, of approximately $2.6 billion of PERA's alternative asset allocation, about $2.5 billion (96 percent) is actively managed. PERA's $3.8 billion fixed income portfolio is 100% actively managed.
- Of ERB's approximately $4.3 billion in public equities, $1.6 billion (38 percent) are actively managed; in contrast, of the $3.2 billion invested in alternatives, $2.4 billion (76 percent) are actively managed. Further, ERB actively manages its entire $3.7 billion portfolio allocated in fixed income assets.
- Of SIC's approximately $18 billion in assets between the LGPF and STPF, $14 billion (78 percent) is actively managed; of their $10.0 billion allocated to public equities, $6.8 billion (68 percent) is also invested by active managers. Further, SIC actively manages its entire investment allocation in the fixed income and alternative asset classes.

<u>Other Investment Agency-Related News</u>

- SIC reports the triennial asset allocation study for the LGPF was approved by the Council in August. The changes will have an immediate effect on the LGPF strategic asset allocation long-term targets by decreasing the exposure of domestic and international equities and of absolute return in favor of fixed income, real return, and private equity. SIC notes fund managers seek to minimize the magnitude of the allocation effect as deviations from policy do not tend to occur intentionally in an effort to increase returns. Pending the voter's decision in the next general election, the long-term targets could change by further decreasing the exposure to domestic equity and increasing the targets in the case of international equity and fixed income asset classes. The council tabled a proposal to amend the strategic allocation long-term targets of the STPF citing concerns about Venture Capital returns and requesting additional information on the subject.
- ERB reports it has adopted changes to its strategic asset allocation because the performance and diversification benefits of their current strategy did not justify the cost. The new long-term targets for domestic equities and for fixed income were reduced in favor of alternative investments (real assets, real estate, and private equity). There is no change to their global tactical asset allocation (GTAA) and opportunistic credit targets while the absolute return asset class was eliminated.

- PERA reports the new strategic asset allocation (SAA) approved by its board replaces Liquid Alpha with a new asset class named Fixed Income Plus. According to investment staff, the new SAA aims to optimize returns for the level of risk while recognizing actuarial return thresholds. To do that, the new SAA decreases the long-term targets for domestic equity and absolute return in favor of international and private equities, fixed income, real estate, and real assets.
- In August, the Wall Street Journal reported Goldman Sachs Group Inc., Barclays PLC and other large firms are reducing their roles as middlemen of repurchase agreements known as repo markets, a pullback analysts and banks say could make it harder for hedge funds to borrow and for money-market funds to invest. The Wall Street Journal also reports senior Federal Reserve officials have said repo markets remain unstable, raising the prospect of further limits on the role of big banks. Investment staff of the Office of the State Treasurer has started researching tri-party repo market alternatives such as collateral agent counterparty expansion, open repos, term repos, and commercial paper to manage over $615 million in short-term assets of the general fund investment pool liquidity portfolio.
- In July, the Wall Street Journal reported officials at the California Public Employee's Retirement System (CalPERS), the largest public pension fund in the U.S., are reducing their investments in hedge-funds by 40 percent to $3 billion mostly because of concerns about high fees and small returns. All three of New Mexico's investment agencies have recently approved changes to their strategic asset allocations of Absolute Return by reducing long-term exposure of fund-of-funds.

Figure 9 - Investment Agency Strategic Asset Allocation Targets